Internal Revenue Service

memorandum

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Br1:WEWilliams

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to: Mr. Theodore J. Kletnick
International Special Trial Attorney CC:NA

from: Acting Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted]

This is in further reference to your request for informal technical advice. We gave you our views on your first question concerning applicability of the safe haven interest rate in a memorandum dated March 16, 1989. This memorandum responds to your second and last question.

Your question relates to Example (1) in section 1.482-2(d)(1)(ii)(d) of the Treasury Regulations.[1]/ This is one of three examples illustrating the principles of subdivision (ii) dealing with the transfer or use of intangible property. Subdivision (ii)(a) of the Regulation holds that:

1. Where there is no bona fide cost-sharing arrangement and one member of a related group undertakes the development of intangible property, no allocation with respect to the development is made until any property resulting from the development activity is "transferred, sold, assigned, loaned, or otherwise made available" to another member of the group.

2. Where a member of the related group acquires an interest in the property resulting from the development activity, the developer's transfer is subject to the rules of section 1.482-2(d) of the Regulations.

Subdivision (ii)(b) of the Regulation generally holds that:

1. Where one member of a related group assists a developer that is a member of the same group in the development of intangible property, the

[1]/ Treas. Reg. § 1.482-2 was promulgated by T.D. 6952, 1968-1 C.B. 218.

amount of any appropriate allocation as a result of such assistance is determined under the relevant paragraph or paragraphs of section 1.482-2 of the Regulations (e.g., loans, services, or use of tangible or intangible property).

Subdivision (ii)(c) of the Regulation holds that:

1. The issues concerning identification of a developer and whether any assistance is being rendered to a developer by another member of a related group of which the developer is a member, depend on the facts and circumstances of each case.

2. The factors given most weight in making these determinations are "the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity ...."

3. "Risk" in this connection means the possibility that the activity will not result in the development of intangible property or that any intangible property will not allow recovery of the costs of development.

4. A member of the group will not be considered to have "borne" risks and costs of development, unless a commitment to bear such costs and risks is made in advance of or contemporaneously with their incurrence and without regard to the success of the activity.

5. Other relevant factors in determining whether a member of a related group is a developer: location of development activity, capability of members to carry on the activity independently, and the degree of control exercised by various members over the activity.

Example (1) under subdivision (ii)(d) is as follows:

X, at the request of Y, undertakes to develop a new machine which will function effectively in the climate

> in which Y's factory is located. Y agrees to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. Assume that X does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and Y obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances as stated, Y shall be considered to be the developer of the intangible property and, therefore, Y shall not be treated as having obtained the property in a transfer subject to the rules of this paragraph. Any amount which may be allocable with respect to the assistance rendered by X shall be determined in accordance with the rules of (b) of this subdivision.

You ask us to assume, in connection with Example (1), that:

1. X is a U.S. corporation, and Y is a foreign corporation.

2. All of X's development activities take place in the U.S.;

3. Y obtains a patent on the machine, and at the time the patent is obtained, it has a fair market value of $30 million;

4. Under a cost-plus method applied to X's services in developing the patent, Y makes a payment of $1 million to X.

5. Income in excess of $100 million is realized by Y outside the U.S., and there is no income directly realized in the U.S.

You ask for our views on the U.S. income tax consequences.

In the case of the development of intangible property (e.g., a patent) by one member of a related group, no allocation attributable to such development activity is made until the property developed, or an interest in the property, is or is deemed to be transferred in some manner. Treas. Reg. § 1.482-2(d)(1)(ii)(a). The one exception to this rule is where another member of the group renders assistance to the developer in connection with the development activity. When this occurs, an allocation may be made to reflect the fair market value of the assistance. Treas. Reg. § 1.482-2(d)(1)(ii)(b). Under Example 1 and your assumed facts, Y (the developer) has apparently paid X $1 million to reflect the value of X's services in developing the patent for Y, and you have not indicated that further allocation is necessary relative to the assistance rendered by X.

We do not think that any of the facts that you ask us to assume change the holding of Example 1 that Y, rather than X, is the developer of the patent. In this regard, X has borne none of the costs or risks associated with the development of the patent; Y has borne all of the risks through its agreement with X to pay all costs of the development activity. X is essentially functioning as a contract researcher being paid for its actual services; under these circumstances, X is not expecting to reap any rewards/profits from use of the patent by Y. Neither is X expected to incur any loss that might result if the development activity fails to produce a patent/machine that will be usable by Y or a patent from which Y will be unable to recoup its costs of development.

The assumptions you ask us to make cause the facts in Example 1 to be superficially similar to the facts in the Puerto Rican drug company cases. See, Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, and remd. __ F.2d __ (7th Cir. 1988); and Searle & Co. and Subsidiaries v. Commissioner, 88 T.C. 252 (1987). However, we think that there are critical differences between the facts in Example 1 (with your assumptions) and the facts in the drug company cases.

In the drug company cases, generally, a U.S. corporation incurred considerable expense, which was currently deducted on its U.S. returns, in developing a valuable drug patent. After obtaining the patent, the U.S. corporation transferred it to a Puerto Rican company in exchange for all of the company's stock (i.e., an I.R.C. § 351 transfer). The Puerto Rican subsidiary then manufactured the drug (a relatively simple and inexpensive operation) and sold the finished drug, either back to its parent or to third parties at enormous profit. Thus, all of the income from the patent was sourced in Puerto Rico and reported by the subsidiary.

The IRS's position in the drug company cases was that parties dealing at arm's-length would never transfer income-producing intangibles without provision for the payment of royalties or a lump sum. Because return on investment and income in the pharmaceutical industry is attributable almost exclusively to investment in research, development, and marketing, and only incidentally to the actual manufacturing process, the IRS argued that the U.S. parent's transfer of a drug patent to its Puerto Rican subsidiary significantly distorted the income of both the transferor and transferee and that this distortion was aggravated by the fact that virtually all of the research and development expenses involved were being currently deducted by the taxpayer, even though it was being deprived of much of the income attributable to these expenditures.

To remedy the misallocation, the IRS essentially treated the Puerto Rican subsidiary as a contract manufacturer, allowed the subsidiary location savings, included the location savings in cost, and permitted the subsidiary a manufacturing profit of cost plus 30 percent. The balance of the subsidiary's income was reallocated by the IRS to the U.S. parent.

The critical difference between the drug company cases and Example 1, as modified by your assumptions, is that under the Example there is no transfer of an intangible between related parties and no sales of products produced from the intangible by one related party to another. The only transaction in the Example that is subject to evaluation and possible adjustment under section 482 is the assistance that X afforded Y in developing the patent. This results from the fact that Y is deemed to be the developer and, therefore, the owner of the patent. We do not, however, believe that X's services in the form of assistance in developing the patent will serve as a basis for allocating to X any of Y's profit from use of the patent. Until there are facts indicating that X, rather than Y, is the developer of the patent, under the guidelines in section 1.482-2(d)(1)(ii)(c) and the examples in subdivision (d), there is no basis for allocating to X some of the income realized by Y from the patent.

Our view of Example 1, as modified by your assumptions, is consistent with the Tax Court's findings with respect to a similar issue , regarding development of patents for herbicides and defoliants, in Ciba-Geigy Corp. v. Commissioner, 85 T.C. 172, 230-237 (1985). In Ciba-Geigy, the only adjustment upheld by the court was a minor one to compensate the U.S. assistor for its contribution to the development of the intangible property. The amount of the adjustment was de minimus when compared to the value of the intangible.

This memorandum responds to your informal request for legal advice and does not constitute a formal technical advice memorandum. Because it discusses matters in anticipation of litigation, a copy of this memorandum should not be furnished to the taxpayer.

GEORGE M. SELLINGER